

**MEMORANDUM**

**TO:** File No. S7-14-11

**FROM:** Steven Gendron  
Analyst  
Office of Structured Finance  
Division of Corporation Finance  
U.S. Securities and Exchange Commission

**RE:** Meeting with Representatives of Pentalpha Surveillance, LLC

**DATE:** October 9, 2012

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On October 3, 2012, Rolaine Bancroft, Steven Gendron, David Beaning, and Arthur Sandel of the Division of Corporation Finance and Stanislava Nikolova of the Division of Risk, Strategy, and Financial Innovation met with Jim Callahan of Pentalpha Surveillance, LLC and Jay Knight of Bass, Berry & Sims PLC. The discussion included, among other things, the Commission's Proposed Rules for Credit Risk Retention. Handouts are attached to this memorandum.

Attachment

# Proposed Governance Enhancements

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Pentalpha Surveillance, LLC

October 2012

# Purpose of Meeting

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- To draw attention to developing trends in trust governance practices.
- Discuss Pentalpha's proposed governance enhancements to improve the performance of loan pools collateralized by real estate, corporate and consumer debt obligations. If there is a trustee, there should also be an Operating Advisor.
- Encourage regulator interaction with industry trade associations on this important topic to get to a final industry template.
- Discuss difference between governance and master servicing. Master servicing alone has been insufficient for many investors.

# Current developments in trust governance

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- CDOs and re-REMICs
- Origination-related matters
  - Rep and warranty claims
  - Collateral quality checking (due diligence)
- Servicing-related matters
- Investor communication

# Current developments in trust governance (cont'd)

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- Current nomenclature in governance vendors
  - RMBS --> Trust Oversight Advisor and Credit Risk Manager
  - CMBS --> Senior Trust Advisor and Operating Advisor
- For discussion purposes, we call the governance vendor an Operating Advisor

# Current developments in trust governance (cont'd)

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- No OA minimum qualification standards and consistency in best practice operations
  - Wide variability among issuers and dealers as to governance protections offered to investors
  - No minimum standard as to collateral quality checking. Some recent deals have been saying that no party to the pooling and servicing agreement is under a duty to review the mortgage loans to determine whether the reps and warranties made by the loan seller are true.
  - Governance enhancements introduced shortly after the financial crisis are becoming weaker

# Current developments in trust governance (cont'd)

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- No OA independence criteria
- OA potential conflicts of interest increasingly a concern of investors
  - Some recent offering documents simply acknowledge the potential lack of independence. For example-

“The trust advisor serves as special servicer in other commercial mortgage securitization transactions and has advised us that it intends to continue to serve, or reserves the right to serve, as a special servicer with respect to existing and new commercial, multifamily and manufactured housing community mortgage loans for itself and its affiliates and for third parties, including portfolios of mortgage loans similar to the mortgage loans included in the trust fund. These other mortgage loans and the related mortgaged properties may be in the same markets as, or have owners, obligors or property managers in common with, one or more of the mortgage loans in the trust fund and the related mortgaged properties. As a result of the investments and activities described above, the interests of the trust advisor and its affiliates and their clients may differ from, and compete with, the interests of the trust fund.”

# Current developments in trust governance (cont'd)

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- Limited Operational Minimum Standards + No OA Independence Criteria + Yield-Chasing Environment = Race to the Bottom

# A Call to Improve Governance

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- We urge industry trade associations and regulators to adopt minimum standards with respect to-
  - The responsibilities of an Operating Advisor, and
  - Independence requirements.
- Each asset class will have its own technicals
- Governance in structured finance should be modeled after the role of a board of directors in a corporation. That is, an independent party should be charged with overseeing those that are responsible for the day-to-day activities of the firm. This independent party is, in turn, overseen by the owners of the firm.

# Minimum OA Independence Criteria

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- We recommend the following minimum independence requirement for OAs:
  - The OA should not be affiliated with, nor have a material relationship with or material financial interest in, any sponsor, originator, depositor, servicer, pool asset, or obligor of a pool asset in the securitization, nor be engaged, or through an affiliate be engaged, in the business of a sponsor, originator, depositor, or servicer.
    - A “material relationship” could include (i) providing audit services to, (ii) having an active and/or material ongoing referral relationship with, (iii) having a principal investment in, (iv) providing legal services to, or (v) being an active principal trading counterparty with, a participant in the securitization. Also, with respect to a pool asset or obligor of a pool asset, a “material relationship” could include maintaining servicing responsibility or engaging in due diligence services on a pool asset, or having an ownership interest in such pool asset or obligor, such as through ownership in another part of the capital structure in the reference deal or CDO/re-REMIC aggregation activities.

# Recommended OA tasks

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- Suggested Pre-Closing Tasks:
  - Duty to review applicable transaction documents with a view toward enhancements, such as operational process deficiencies, rep and warranty compliance procedures, and ambiguous or missing definitions.

# Recommended OA tasks (cont'd)

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- Suggested Post-Closing Tasks Related to Collateral Quality:
  - Duty to conduct collateral quality reviews, including sampling loans in the pool for rep and warranty compliance;
  - Duty to refer potential rep and warranty violations to the trustee and/or servicer;
  - Duty to oversee disclosure to investors of OA rep and warranty referrals; and
  - Discretion to recommend to the trustee that it consider binding arbitration on put-back demands that are not resolved timely, provided parties previously consented to arbitration.

# Recommended OA tasks (cont'd)

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- Suggested Post-Closing Tasks Related to Servicing Oversight:
  - We propose an increasing level of oversight depending on collateral performance and the subordinate investor's controlling interest.
  - Each asset class will have its own technicals.
  - The CMBS example on the following slides are based on the current market practice of three "control" periods: subordinate control period, co-consultation period, and senior control period.

# Recommended OA tasks (cont'd)

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- Suggested Post-Closing Tasks Related to Servicing Oversight (cont'd):
  - CMBS example:
    - During “Subordinate Control Period”-
      - Duty to conduct periodic face-to-face meetings with the servicer;
      - Duty to monitor the monthly Early Payment Default (EPD)/watch list loans;
      - Duty to review certain specific reports, including final asset status reports;
      - Duty to prepare an annual report to investors setting forth the OA’s assessment of whether it believes, in its sole discretion exercised in good faith, that the servicer’s performance on a “platform-wide basis” complies with the servicing standard as defined in the governing documents with respect to the resolution and liquidation of specially-serviced loans; and
      - Discretion to put servicer removal to an investor vote.

# Recommended OA tasks (cont'd)

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- Suggested Post-Closing Tasks Related to Servicing Oversight (cont'd):
  - During “Co-Consultation Period”-
    - OA continues to have the duties from the Subordinate Control Period, plus-
    - Duty to consult with the servicer and subordinate investor with respect to the servicer’s resolution plan reports for individually troubled loans. The servicer would not be obligated to act on the OA’s recommendations; and
    - Duty to review and recalculate the servicer’s net present value (NPV) calculations.

# Recommended OA tasks (cont'd)

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- Suggested Post-Closing Tasks Related to Servicing Oversight (cont'd):
  - During “Senior Control Period”-
    - OA continues to have the duties from the Subordinate Control Period and Co-Consultation Period, plus-
    - Duty to consult with the servicer in the creation and implementation of an individual loan’s workout plan, including approving all major servicing decisions.

# Recommended OA tasks (cont'd)

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- Suggested Post-Closing Tasks Related to Investor Communication:
  - Duty to submit required annual assessment on Reg AB compliance with applicable servicing criteria;
  - Discretion to hold semi-annual conference calls with investors arranged through the trustee; and
  - Discretion to answer one-off inbound calls to OA at any time, subject to confidentiality restrictions.

# Key Takeaways

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- A lack of minimum standards related to governance practices combined with the low interest rate environment is creating a race to the bottom.
- Governance enhancements, like the ones suggested today, are a cost-effective solution to help improve the performance of structured finance markets through multiple economic cycles as well as provide transparency to investors.
- An OA must be fully independent to gain the confidence of investors. A regulatory prohibition of an affiliation to a servicer, sponsor, originator, depositor, loan due diligence firm or investor should not be limited to only transaction participants.